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SIPDIS, SENSITIVE

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SUBJECT: Austrian Government Takes Over Hypo Alpe Adria Banking
Group after Crisis Weekend

REF: VIENNA 1479

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Sensitive but unclassified -- protect accordingly.

¶1. (SBU) SUMMARY: On December 14, the GoA nationalized Hypo Alpe Adria (HAA) -- Austria's sixth largest bank -- in concurrence with the bank's private shareholders. HAA's troubles were increasingly evident (reftel) and the GoA took the step (in consultation with the ECB and the provincial governments of Carinthia and Germany's Bavaria) in order to prevent a collapse of confidence in the bank, ensure its long-term liquidity, and avoid broader fallout from a bankruptcy/liquidation. While HAA is now safe, the GoA will have to restructure the group and may split it into "good" and "bad" banks. GoA FinMin Proell and central bank governor Ewald Nowotny criticized HAA's erstwhile owners, particularly the governments of Bavaria (the former owner of BayernLB) and Carinthia, for bringing a major bank to the precipice. HAA subsidiaries are among the largest banks in southeast Europe; their future is now in GoA hands and subject to EU scrutiny of state aid. END SUMMARY.

An Extraordinary Step

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¶2. (SBU) A weeks-long standoff over recapitalizing HAA (reftel) -- fought between Austria's Finance Ministry (MoF) and HAA's owners Bayerische Landesbank/BayernLB (67%), the provincial government of Carinthia (12.5%) and GRAWE insurance company (20.5%) -- culminated in a weekend of frenzied negotiations among Austrian, German, and ECB policymakers and bankers, resulting in agreement on GoA takeover terms. FinMin Josef Proell announced the decision on the morning of December 14, less than an hour before HAA branches opened. NOTE: Absent the GoA move, the bank might have been unable to open (if it had reported a Tier 1 capital ratio below the legal minimum of 4%) or could have experienced a run on deposits - END NOTE. FinMin Proell said the move was closely coordinated with Austrian Chancellor Werner Faymann, Austria's Nationalbank, the German Bundesbank, and the ECB.

¶3. (U) Details of the agreement:

-- The GoA will take over 100% of the bank, paying each of its former owners (BayernLB, state of Carinthia, GRAWE insurance) a symbolic one Euro;
-- HAA's three former owners will provide EUR 1 billion in fresh equity to HAA (BayernLB EUR 825 million, Carinthia EUR 200 million, GRAWE EUR 30 million). The GoA will add EUR 450 million in equity. In sum, this gives HAA the EUR 1.5 billion it reportedly needs to put its Tier 1 capital ratio above 8% (the de facto minimum to obtain liquidity and do business internationally); without the injection, HAA would reportedly have fallen below the 4% regulatory floor.

-- HAA's former owners will provide EUR 3.4 billion in liquidity to HAA (BayernLB EUR 3.075 billion, Carinthia EUR 227 million, GRAWE EUR 100 million).
-- Austria's other large banks will together provide c. EUR 500 million in liquidity. If some of those funds are used for recapitalizing HAA, they will reduce the aforementioned EUR 450 million GoA equity injection. COMMENT: this kind of "collective rescue effort" is typical crisis behavior for Austria's close-knit financial sector. END COMMENT.

Why Government Takeover, Not Receivership?

14. (U) As Austria's sixth largest bank, HAA was designated "system relevant" by Austrian authorities (i.e. "too big to fail") and court-supervised receivership (or outright collapse) would have had unforeseeable consequences for Austria's banking system, along with repercussions for other banks in the Euro-zone and in southeast Europe -- particularly in Croatia and Bosnia/Herzegovina (HAA is the largest bank in both countries). At a press conference attended by an Embassy representative, central bank governor Nowotny said that liquidating HAA would have threatened market confidence in banks serving the entire CESEE area. NOTE: besides Bosnia-Herzegovina and Croatia, HAA is heavily engaged in Slovenia, Serbia, and Montenegro. Of HAA's total assets, only 46% are in Austria and 12% in Italy, while 16% are in Croatia, 11% in Slovenia, 6% in Bosnia-Herzegovina, 4% in Serbia and 5% in other countries.

GoA Pans States of Bavaria, Carinthia

15. (U) FinMin Proell and Governor Nowotny had harsh words for HAA's owners -- particularly the Bavarian state government (as owner of BayernLB) and the Carinthian government -- for irresponsible behavior in leading HAA to the edge of bankruptcy. Nowotny

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criticized BayernLB and the Bavarian government for trying to simply drop a system-relevant subsidiary on a foreign government's doorstep (a "moral hazard" issue in his words) -- and opined that the GoA had shown responsibility, a view Nowotny said was shared by ECB President Trichet. Nowotny also criticized Carinthian authorities (who controlled HAA until its majority sale to BayernLB in 2007), acknowledging that many of HAA's financial problems date back to that era.

Criminal Investigation Ongoing

16. (SBU) According to media reports, Austrian investigators are looking into possible criminal behavior at Hypo Alpe Adria -- including potential fraud connected with the 2007 sale to BayernLB and criminal connections in southeast Europe. A prosecutorial spokesperson said the investigation "is just starting," and would not speculate on timing or targets. Governor Nowotny called publicly for an "in-depth" criminal investigation and appropriate prosecution.

How We Got Here: An Insider View

17. (SBU) On December 1, in the lead-up to HAA's takeover, Governor Nowotny told the Ambassador that HAA would likely be rescued in consultation with its shareholders including the state of Bavaria. Nowotny admitted that the central bank had known of Hypo's troubles for some time -- and opined that there may well have been criminal behavior -- but argued that bank regulators cannot "go public" with such knowledge ("the bank would collapse instantly") and instead has to work behind the scenes to reach a solution. Nowotny said that some of Hypo's problems likely date from before 2007, but Bavarians bear responsibility too for their "hubris" in over-reaching during the financial boom.

COMMENT

¶8. (SBU) HAA is safe for now, but likely faces radical restructuring. Although no details have been announced, Nowotny has floated the prospect of splitting HAA into "good" and "bad" banks. Also unclear is what will happen to HAA's foreign subsidiaries, some of which are market leaders in southeast Europe. As 100% owner of HAA, the GoA will have to make these decisions -- but will have to justify its behavior to European Commission competition authorities, who may take issue with HAA careening from one form of state aid (Bavaria/BayernLB) to another.

¶9. (SBU) After years of sweeping HAA's problems under the rug, the Austrian banking system is now stuck with the most serious de facto failure in decades (even more costly than the BAWAG/Refco accounting fraud debacle in 2005). While a radical step, this takeover is still likely to be the least costly solution for the GoA given the Carinthian state government's EUR 18-19 billion in guarantees for HAA assets -- guarantees that could have come due if HAA had been allowed to collapse, and would surely have landed in the GoA's lap. With this negotiated approach, the GoA has also managed to extract more capital and liquidity from HAA's former owners, most of all BayernLB, reducing the risks to HAA, Austrian banking generally and the GoA's fiscal position. END COMMENT.

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